

**BEFORE THE PUBLIC UTILITIES COMMISSION
OF THE STATE OF HAWAII**

**In The Matter Of the Application Of
PUBLIC UTILITIES COMMISSION**

**Instituting a Proceeding to Investigate Competitive
Bidding for New Generating Capacity in Hawaii.**

DOCKET NO. 03-0372

REPLY BRIEF

AND

CERTIFICATE OF SERVICE

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This Reply Brief is respectfully submitted on behalf of HAWAIIAN ELECTRIC COMPANY, INC. (“HECO”), HAWAII ELECTRIC LIGHT COMPANY, INC. (“HELCO”) and MAUI ELECTRIC COMPANY, LIMITED (“MECO”)¹ in response to the opening brief filed by Hawaii Renewable Energy Alliance (“HREA”), and to respond to certain comments in the Opening Brief and Responses to Commission’s Post-Hearing Questions (“CA Responses”) filed by the Department of Commerce and Consumer Affairs, Division of Consumer Advocacy (“Consumer Advocate” or “CA”).

The HECO Companies Opening Brief filed June 6, 2006 generally addresses the contentions included in the other parties’ Opening Briefs.² Therefore, this Reply Brief will not attempt to be all-inclusive, and will focus on those contentions that may warrant further response.

¹ HECO, HELCO, and MECO are collectively referred to as “HECO Companies” or “Company”.

² References to the HECO Companies Opening Brief are intended to incorporate the references to the record and authorities cited in the Opening Brief. The citations generally will not be repeated in this Reply Brief for the sake of brevity.

I. DISCUSSION

A. COMPETITIVE BIDDING PROCESS

1. Utility Self-Build Proposal

a. HREA's Recommendation

HREA's position is that an Investor Owned Utility ("IOU") should not be allowed to bid on new wholesale power, and that turnkey projects should not be allowed, but that an IOU "should be allowed to establish a utility-affiliate for the purpose of competition for the provision of wholesale power to the grid."³

HREA does not offer any analysis, or discussion of the practices in other jurisdictions, in support of its position. Instead, HREA offers the following:

HREA believes there is a significant imbalance in favor of the Investor Owned Utility (IOU) compared to the ratepayer. The ratepayer needs some relief, and the best way to provide that relief would be to preclude further ratebasing of utility, self-build projects and requiring the IOU to bid out all new generation.⁴

HREA's recommendation should be rejected as it is unreasonable and fails to consider the circumstances surrounding the utility systems in Hawaii.⁵ The utility is not simply a potential competitor in its own request for proposal ("RFP") process. The utility, along with its customers and its system, are intended beneficiaries of any RFP process that is pursued or mandated. HECO Companies OB at 67.

It is the utility that has the obligation to serve. In Hawaii, the utility is not simply a provider of service, or the default provider of service, but is the provider of service. HECO Companies OB at 68. It is important to recognize that the needs of isolated utility systems in

³ HREA OB at 7, 8, 57.

⁴ HREA OB at 6-7.

⁵ The HECO Companies discussed the unique nature of the Hawaii electric system relative to mainland systems in Exhibit "B" to the HECO Companies Opening Brief.

Hawaii are significantly different from the utility systems on the mainland, which needs to be taken into account in the design and development of a competitive bidding process and the associated rules and guidelines. In many areas of the U.S. mainland, utility systems are part of a larger regional market, which provides utilities with access to a range of power supply options and products and reduces reliability risk. (In a number of instances, these include existing merchant plants.) In these systems, failure of the supplier to deliver could result in the buyer being indemnified based on the financial penalties contained in the power purchase agreement. The financial nature of the contract provides the utility the opportunity to purchase replacement power at market prices. The seller has to compensate the utility for the difference between the contract price and the market price. The utility is made financially whole and still has access to reliable power supplies in the broader market. HECO Companies OB at 3.

In an isolated power market such as Hawaii, the inability to procure other sources of power could be devastating. There is no “broader market” from which replacement power could be obtained. The utility needs the physical power to meet customer reliability requirements. HECO Companies OB at 3-4.

Contrary to HREA’s unsupported belief, competitive bidding will not be beneficial in Hawaii unless electric utilities are able to (1) participate as bidders in the process, and (2) conduct the competitive bidding process (which includes ending out the RFP, pre-qualifying bidders, evaluating the bids, and selecting the winning bid or bids. See HECO Companies OB at 68-69. The goal of any competitive bidding process is to encourage and evaluate a range of generation options with the objective of obtaining the lowest reasonable cost option for the customers of the utility. This goal can only be assured if all resource options are allowed to compete. Regulatory commissions have recognized that a utility project may be the lowest

reasonable cost option and failure to allow that option to compete may result in higher cost power options, contrary to their goals and objectives. HECO Companies OB at 69-70.

With regard to host utility self-build options, utilities have been selecting their own build options more frequently over the past few years for several reasons. First, the financial and credit problems faced by independent generators have led to higher debt costs and higher equity ratios for independent generators, virtually eliminating the competitive advantage once enjoyed by independent generators. Utility projects are now competitive from a financial perspective. Second, transmission constraints in a number of markets have led to higher transmission costs for resources located outside the utility service area or in costly transmission areas. Third, the deteriorating credit quality of many independent generators has raised concern over counter party reliability. In turn, power purchase agreements require higher levels of security and tighter damage provisions to protect the utility's customers against the prospect of contract default. There is heightened concern that independent generators are less reliable than host utilities in developing and operating their projects. HECO Companies OB at 69-70.

A utility self-build option for the host utility is common in most RFP processes and is recognized by regulators and third-party bidders as a reasonable role for the host utility.⁶ In fact, in several recent RFP processes, utility self-build or turnkey options have been the successful bidders among a large number of options. HECO Companies OB at 69-70.

Regulatory commissions have recognized that utilities have an obligation to serve and provide reliable service, and have an obligation to do so at lowest reasonable cost. Regulatory commissions also have recognized that acquisition of energy and capacity to meet the needs of

⁶ The HECO Companies discussed how other jurisdictions have dealt with the question of whether a utility should be allowed to submit a self-build option in response to its own RFP. As discussed, a number of jurisdictions allow the utility to submit a self-build option. See HECO Companies OB at 72-73.

customers remains the responsibility of the utility, and that these functions should not be delegated to an independent entity. HECO Companies OB at 69-70.

In other recent RFP processes, self-build options have been allowed and encouraged.⁷ For example, the Oregon Public Utility Commission allowed Portland General to offer a self-build option as a result of a revision to its 1991 competitive bidding rules, which stated that utility self-build options were not eligible to bid. Portland General had to submit its proposal to the Commission in advance of receipt of other bids and had to provide the same information required of other bidders.

The bidding rules in Quebec allow Hydro-Quebec Generation to bid into the Distribution Company's Call for Tenders process as long as everyone abides by the same rules. The Generation Company has been awarded contracts but other independent power producers ("IPPs") have been successful bidders as well.

The Staff Report and Recommendations prepared by the Staff of the Louisiana Public Service Commission in Docket No. R-26172 (Development of Market-Based Mechanisms to Evaluate Proposals to Construct or Acquire Generating Capacity to Meet Native Load), March 13, 2002 (page 4), clearly stated its objectives in considering the competitive bidding process.

As many of the comments correctly recognize, the utilities have an obligation to serve and provide reliable service. They also have an obligation to do so at lowest reasonable cost. This rulemaking does not change those basic principles. Given this obligation, along with episodic problems in recent years associated with wholesale market supply (e.g. price spikes, shortages), the self-build option cannot be "taken off the table" in deference to the market. Moreover, the maintenance of a self-build option for utilities will help serve to discipline and restrain the market in the intermediate and long run.

⁷ HECO Final Statement of Position, Exhibit 1 at 19-20.

Comments of bidders regarding utility participation in the RFP process were summarized in the Order (page 3):

Most commentators, however, recognized that utility projects may be appropriate if they pass a market test. As Semptra's witness states, the purpose of the RFP process is to "get the best deal for ratepayers in terms of cost, risks, reliability and environmental performance". It is possible that a utility self-build project -- vetted through an RFP -- could be the "best deal for ratepayers."

As is provided for in the Proposed Framework⁸, however, there are steps that can be taken in order to encourage bidder participation, and to minimize disputes arising out of the bid evaluation and selection process. The steps that can be considered to facilitate a "fair" process are included in ¶III.H.7 of the Proposed Framework. This section addresses fairness and transparency issues related to the evaluation of a utility proposal against third-party bids in light of the different nature and types of risks associated with a utility and non-utility bid. In addition, this section describes the role of the Independent Observer in the process of evaluating utility proposals or affiliate bids against third party bids. See Tr. (12/14) at 781-82.

It is also unreasonable to restrict a utility's participation in the competitive bidding process through an affiliate. Such a restriction limits the options that a utility may pursue in responding to the RFP. The Proposed Framework addresses steps that can be taken to address concerns regarding the fairness of a process in which the host utility is permitted to respond to the RFP.

The purpose of an RFP is to help the utility and its customers obtain new generation resources that meet the objectives of the IRP "at the lowest reasonable cost", and to facilitate the acquisition of renewable energy resources. The purpose is not to increase the amount of

⁸ The Proposed Framework that was attached as Exhibit "A" to the Stipulation Regarding Proposed Competitive Bidding Framework filed May 22, 2006 by the HECO Companies, Consumer Advocate and Kauai Island Utility Cooperative ("KIUC") is referred to as the "Proposed Framework" or "Framework".

purchased power for the sake of competition, or to provide access to the Hawaii generation market on a “levelized playing field” basis. Making the RFP process unduly costly or resource intensive for small, island utilities would not be in the public interest, or consistent with the purpose of issuing an RFP. HECO Companies OB at 68.

b. HREA’s Other Comments

Percentage of Purchased Power

HREA also asserts that “ownership and operation of generation is already overly concentrated in the hands of Hawaii’s electric utilities” HREA OB, Exhibit A at 15. See also Exhibit A at 57. Contrary to HREA’s assertion, the HECO Companies already are committed to purchase a high percentage of firm capacity and energy from IPPs, and increasing the percentage of purchased power while maintaining the reliability of the utility’s system will be challenging.

The percentage of firm capacity provided by IPPs on HECO’s system has increased from 0% prior to 1990 to approximately 26% once Amendment Nos. 5 and 6 to HECO’s amended purchase power agreement (“PPA”) with Kalaeloa Partners, L.P. became effective. The percentage of HECO’s baseloaded capacity provided by IPP’s is even higher – about 35%. The percentage of power provided by IPPs on Hawaii is even greater.

	2004 IPP Capacity as a Percent of Firm Capacity	2004 IPP Generation as a Percent of Total Net-to- System Generation	2006 IPP Capacity as a Percent of Firm Capacity	2006 IPP Generation as a Percent of Total Net-to- System Generation
Oahu	25%	39%	26%	42%
Maui	6%	7%	6%	16%
Hawaii	37%	65%	33%	64%

See Exhibit E to HECO's Comments filed September 26, 2005 on Economists Incorporated's Second Concept Paper dated July 26, 2005 "Proposals for Implementing Renewable Portfolio Standards in Hawaii".

HECO has been able to manage the integration of the Kalaeloa, AES Hawaii, Inc. and H-Power facilities into its system, but there is substantial uncertainty as to how much more firm power could be purchased without substantial negative impact on HECO's operational flexibility. Moreover, it is expected that there will be opportunities in the future to purchase additional renewables on a firm capacity basis (for example, if an additional waste-to-energy capacity is added at Campbell Industrial Park), and if the percentage of purchased power is increased, it should be accompanied with the benefit of adding renewables.

Integration of Purchased Power into Utility Systems⁹

While a generating resource generally may be installed under either a utility or an IPP ownership structure, the utility's control over the resource differs substantially depending on whether the utility owns the resource, or obtains the resource under a PPA. The presence of a PPA between the utility and an IPP does not provide the utility with as much operating flexibility as the utility has with its own units. While the PPA can specify operating conditions favorable to the utility (such as coordination of maintenance, dispatchability, etc.), the utility generally has less control over plant maintenance practices, operational considerations, fuel conversion opportunities, and environmental enhancements. In contrast, the utility has such operating flexibility with its own units.¹⁰

⁹ See HECO Companies OB at 154-56 & Exhibit A.

¹⁰ HECO, for example, has been able to manage the integration of the Kalaeloa, AES and H-Power facilities into its system, but there is substantial uncertainty as to how much more firm power could be purchased without substantial negative impact on HECO's operational flexibility.

Utilities also have the obligation to serve their customers while IPPs who supply capacity and energy to the utilities under PPAs may be obligated to provide to the utility only those items and services, or to perform only those duties, that are covered by provisions in the PPA. At times, this can constrain the utility's operating flexibility. As a result, a utility has much more flexibility to adjust to changed circumstances if it owns and operates its own units, than if it purchases power under long-term PPAs, because PPAs cannot be drafted to provide for all future contingencies and changed circumstances.

In addition, under state energy policy, the utility's focus is first on acquiring new renewable energy generation. That means that the competitive bidding process, if any, should facilitate the acquisition of renewable energy generation, and that other types of generation added to the system should accommodate the introduction of more renewable energy generation to the utility's system. It is expected that there will be opportunities in the future to purchase additional renewables on a firm capacity basis (for example, if an additional waste-to-energy capacity is added at Campbell Industrial Park), and if the percentage of purchased power is increased, it should be accompanied with the benefit of adding renewables.

2. On-Going Projects

HREA proposes that for the HECO Companies' three on-going projects (i.e., HECO Campbell Industrial Park CT-1, HELCO Keahole ST-7, and MECO Maalaea M-18), the Commission should solicit letters of interest from bidders for the purchase of these pending projects or potential alternate projects and make these projects subject to an abbreviated competitive process. HREA OB, Exhibit A at 1. HREA claims that "[t]he elements of the [abbreviated competitive] process should be the same as those for a normal competitive bidding solicitation." HREA OB, Exhibit A at 4.

HREA's proposal should be rejected. First, the Consumer Advocate, the HECO Companies and KIUC have agreed and codified the following in Paragraph I.A.3.c. of the Proposed Framework:

Competitive bidding may not be appropriate in the case of (i) the expansion or repowering of existing utility generating units, (ii) the renegotiation of existing power purchase agreements, (iii) the acquisition of near-term power supplies for short-term needs, (iv) the acquisition of power from a non-fossil fuel facility (such as waste-to-energy facility) that is being installed to meet a governmental objective, and (v) the acquisition of power supplies needed to respond to an emergency situation.

This Framework does not apply to (i) the following utility projects currently being developed, including: HECO Campbell Industrial Park CT-1, HELCO Keahole ST-7, and MECO Maalaea M-18 or to (ii) offers to sell energy on an as-available basis by non-fossil fuel generation producers that are under review by an electric utility at the time this Framework is adopted." [Emphasis added.]

Pages 4 through 7 of the Consumer Advocate's Responses to Commission's Post-Hearing Questions stated that "...there should be no requirement to issue a request for showing/statement of interest ("RFI") for generation that would address the need to be served by these units." and that "... [t]he Consumer Advocate's agreement to exclude these projects [from the competitive bidding process] stems from the Consumer Advocate's recognition that requiring competitive bidding for the identified projects may not be in ratepayers' best interest." and explain why at length.

Second, HREA's proposal is superficial and does not contain any details, and ignores the "real world" facts surrounding these on-going projects.

HREA provides no detail as to (1) how the request for showing of interest and the abbreviated competitive process should be conducted (e.g., content of the request for showing of interest, how the request for showing of interest would be developed, how the abbreviated competitive process would be developed), (2) how the process can be completed in time to meet

the need dates for the three on-going projects (as discussed in the HECO Companies Opening Brief the planned in-service dates for the HECO unit is in the 2009 timeframe, the MECO unit is in the 2006 timeframe, and the HELCO unit is in the 2009 timeframe), or (3) why or how the existing projects should be “sold” to IPPs given the nature of the projects¹¹.

The HECO Companies Opening Brief (pages 20 to 28) provided a discussion of the impracticality of completing a request for showing of interest and abbreviated competitive process for the three on-going projects. In summary, (1) it is not possible to issue a request for showing of interest, to be followed by an “abbreviated competitive process” in time for the units to be available when needed by the utilities, and (2) given the non-binding nature of a request for showing of interest, it is not clear what benefit the utility and its ratepayers would receive by issuing a request for showing of interest.

It does not make sense to attempt to apply a new competitive bidding process retroactively to these three on-going projects, given (1) their status, (2) their timing, and/or (3) the nature of the projects. With respect to MECO Maalaea Unit 18, an alternative ownership option was considered impractical, as the installation of that unit will complete the conversion of MECO’s existing simple cycle combustion turbines Maalaea Units 17 and 19 to a 2-on-1 combined cycle unit. The conversion requires that two heat recovery steam generators and a steam turbine-generator (Unit 18) be integrated with the existing Units 17 and 19. Unit 18 will be installed on MECO property and it is impractical to demarcate boundaries and associated responsibilities for all utility and non-utility facilities, including buildings, access lanes, laydown areas, and integrated piping, ductwork and wiring, if Unit 18 was to be non-utility owned. Moreover, non-utility ownership of Unit 18 would likely require duplication of utility and non-

¹¹ For example, why would it make sense or even be feasible for MECO or HELCO to sell the heat recovery, steam turbine generator phase of a dual-train combined cycle unit to an IPP.

utility operational and maintenance staffs, resulting in higher overall operational expense and unwieldy complications in the coordination of work and schedules for the integrated combined cycle unit. However, although it is impractical for Unit 18 to be non-utility owned, all major equipment and construction services for Unit 18 has been or will be procured through competitive bidding processes. HECO Companies OB at 21.

If, instead, a competitive bidding for new generation process were used to secure stand alone replacement capacity that would otherwise be provided by utility installation of Unit 18, the conversion of Units 17 and 19 to combined cycle would not occur (or would occur at a much later date), and the opportunity to increase the generating efficiency of Units 17 and 19 would be lost or substantially delayed. HECO Companies OB at 21-22.

Similarly, with respect to HELCO's Keahole ST-7, installation of that unit will complete the conversion of existing simple cycle combustion turbines Keahole CT-4 and CT-5 to a 2-on-1 combined cycle unit. The same concerns about competitively bidding the Maalaea Unit 18 would apply to Keahole ST-7. In addition, the completion of ST-7 is needed to place baseloaded generating capacity on the west side of the island for voltage support. HECO Companies OB at 22.

With respect to HECO's simple cycle combustion turbine peaking unit at Campbell Industrial Park, competitive bidding was not considered for a number of reasons. HECO currently has an urgent need for firm generating capacity. Efforts to install a simple cycle peaking unit at Campbell Industrial Park have been under way since early 2003. Although the capacity to be provided by the unit is needed now, the unit is not expected to be installed sooner than 2009, because of the long lead time for environmental review, permitting and approvals, equipment procurement and construction. It would not be practical for this unit to be subject to

competitive bidding, because a well-designed and effective competitive bidding process cannot be put into place and completed soon enough. HECO Companies OB at 20-21.

3. HREA's Example of Milestones and an Estimated Timeline

HREA provided an example of milestones for the competitive bidding process and the installation of projects selected through the competitive bidding process along with estimated time periods to achieve the milestones. See HREA OB, Exhibit A at 26.

HREA's example of milestones and the estimated time to achieve the milestones is unrealistic and should not be considered by the Commission. First, HREA provided no support for its proposed time periods to achieve the milestones. (HREA did not provide any reference to the evidentiary record in this docket in support of its estimated time periods.) In contrast, the HECO Companies presented the expert testimony of Wayne Oliver on this subject. For example, Mr. Oliver testified that in the case of Portland General in Oregon, it took 27 months to develop an RFP, obtain bids and negotiate and execute contracts. HECO Companies OB at 20 (citing the panel hearing testimony of Mr. Oliver). (HREA "suggested" that it would take 15 months from the time the utility announces its intent to issue an RFP to the completion of PPA negotiations. HREA OB, Exhibit A at 26.)

In addition, HREA's example of milestones and the estimated time to achieve the milestones fails to list two of the most important steps in the process to get new generation installed in Hawaii - - (1) obtaining appropriate permits and approvals, and (2) ordering and obtaining delivery of the equipment to be installed as part of the construction of the project. Instead, HREA simply assumes that projects can be installed within 13 to 16 months from approval of a PPA. HREA OB, Exhibit A at 25.

By far the longest part of the process in Hawaii is obtaining the appropriate permits and approvals for new generation. Hawaii has a very limited number of sites that are available to locate new generation, and changing land use designations or zoning in Hawaii in order to acquire new generation sites is difficult and time-consuming with an uncertain outcome. Additionally, extended time must be allotted for permitting and environmental review. HECO Companies OB at 18.

Any combustion based generation will require a Covered Source/Prevention of Significant Deterioration (“CS/PSD”) permit, which is administered by the State of Hawaii Department of Health (“DOH”) and the United States Environmental Protection Agency (“EPA”). The time necessary to apply for and obtain a CS/PSD permit varies widely depending on a number of factors including the size of the unit, its location, and the depth and extent of public participation or opposition. The permit review time period for recent HECO Companies units has varied from as much as 8.8 years (HELCO’s Keahole CT-4/CT-5) to as little as 1.5 years (Maalaea X1-X2). In general, larger units have a longer permit review period than do smaller units. HECO Companies OB at 18.

Besides CS/PSD permitting, all new or expanded fossil-fired electrical generation units with output exceeding 5 megawatts (“MW”) must now undergo environmental review pursuant to Hawaii Revised Statutes (“HRS”) Chapter 343, Hawaii’s Environmental Impact Statement (“EIS”) Law. The time necessary for the HECO Companies to complete the environmental review process under the EIS Law has ranged from 8 to 21 months for large projects (both generation and transmission). The CS/PSD permit will not be issued until the EIS process has been satisfactorily completed. HECO Companies OB at 18-19.

It is also important to understand that the above timeline discussion assumes that the site for new generation is appropriately zoned or has the appropriate land use designation. Rezoning or obtaining a change to the land use designation will only add time to the process. HECO Companies OB at 19.

4. Integrating Competitive Bidding and IRP

The HECO Companies discussed two approaches for conducting the IRP and competitive bidding process in their Preliminary Statement of Position. See HECO Preliminary Statement of Position, Exhibit A at 17-20. In the most common approach, and in the approach adopted by the Proposed Framework, the role of the IRP Plan is to identify the “preferred” resource plan, define capacity and energy requirements, the timing of need, any preferred technologies, and potentially any other preferred attributes. The IRP Plan can also be used to identify any preferences or criteria for resource selection and can be used to determine avoided costs.

A second option, and that proposed by HREA, is to perform competitive bidding within the IRP cycle simultaneously. The drawbacks to this approach are that developers may be unwilling to participate at an early stage in the process, or to freeze prices for the time required to complete the IRP process. While some developers may be willing to submit preliminary bids, they may not be meaningful and could be used to “game” the process since they will not be bidding. Such an approach limits the effectiveness of the IRP Advisory Group, who are exposed to confidentiality issues and disclosure issues associated with potential access to competitive intelligence in the RFP process. This approach is not typical of recent competitive bidding approaches.

HREA contends that the RFP should be developed and issued during the IRP cycle and bids received should be evaluated within the IRP process. HREA further contends that with the

proposed “market-test” approach, the “real cost” of competing options will be revealed. HREA OB, Exhibit A at 7.

The use of competitive bidding as a market test of the IRP would be problematic. A response to an RFP is very costly to put together, and in some cases can cost as much as \$500,000 to \$1 million. Bidders are not going to take the risk of putting together a solid proposal if they are not certain how that information is going to be used or if it is going to be used at all. In addition, much of the information contained in a bid contains competitively confidential information (such as pricing details) that a bidder may be unwilling to share in a public process such as an IRP proceeding. HECO OB at 32.

The Consumer Advocate also pointed out that the use of competitive bidding as a market test of the IRP could be problematic in practice, as there would be little assurance to bidders that the test would lead to real contracts and the bids will likely become stale unless the utility is ready to act promptly as part of the bid review process. CA OB at 24.

B. DESIGN OF THE RFP

1. Standard Offer Contracts

HREA contends that a standard offer contract is needed as an element of the RFP. HREA claims that a bidder will need to know the terms and conditions of the contract in order to prepare a response to the RFP. See HREA OB at 9, 14.

The HECO Companies understand that bidders to an RFP will want to know the terms and conditions of a contract before bidding. The Proposed Framework strikes a balance between recognizing the benefits of providing guidance to bidders in formulating their proposals without requiring the creation of an unrealistic set of contract terms, some of which will be modified or eliminated during contract negotiations between the utility and the project developer submitting

the proposal selected by the utility. The Proposed Framework provides that the terms and conditions of the contracts should be specified to the extent practical, so that bidders are aware of, among other things, performance requirements, pricing options, key provisions that affect risk allocation, and provisions that may be subject to negotiation. Where contract provisions are not finalized or provided in advance of RFP issuance (e.g., because certain contract provisions must reflect features of the winning bidder's proposal such as technology or location), the RFP documentation should so indicate. Proposed Framework, paragraph III.C.1.

The provisions of a proposed contract should address matters such as the following (unless inapplicable): (a) reasonable credit assurance and security requirements appropriate to an island system that reasonably compensate the utility and its customers if the project sponsor fails to perform; (b) contract buyout and project acquisition provisions; (c) in service date delay and acceleration provisions; (d) liquidated damage provisions that reflect risks to the utility and its customers; and (e) contractual terms to allow for turnkey options. Proposed Framework, ¶III.C.2. The proposed contracts may allow the utility the option to request conversion of the plant to an alternate fuel if conditions warrant, with appropriate modifications to the contract to account for the bidder/seller's conversion costs and to assign the benefits of any lower fuel costs. Proposed Framework, paragraph III.C.3.

It is simply not possible to develop a complete contract prior to the issuance of the RFP. A complete determination of what terms are appropriate can only be made after evaluating a bidder's proposal. For example, since many of the non-price provisions affect cost, and ultimately the price offered by the bidder, there is a trade-off between standardization and whether the utility can actually get a workable contractual arrangement. The Company has found in negotiating on a one-by-one basis that most of the non-price provisions that are

significant tend to be subject to negotiation. Many are going to be specific to the technology. Some of the performance standards will be specific to a technology and cannot be standardized. The Company actually went through a process chaired by the Consumer Advocate to try to identify all the provisions that go into the power purchase agreements and try to get some agreements on which ones could be standardized and which ones could not. There were very few inputs to the contract that were identified as being capable of standardization. HECO Companies OB at 55-56.

HREA explained its concept of a “standard offer contract” (“SOC”) by contending that “a SOC is a document that must be signed by the utility if the Bidder agrees with and signs the SOC”. HREA OB at 14; see HREA OB, Exhibit A at 1. HREA contrasted a “model PPA” and a SOC by claiming that “a model PPA is a starting point for negotiations”. HREA OB at 14. HREA’s concept of a SOC is impractical and one-sided in favor of the bidder, and would not further the objectives of competitive bidding.

First, as previously discussed, it is not possible to develop a complete contract prior to the issuance of the RFP. Second, under HREA’s proposal, the utility will be required to sign the SOC that was included in the RFP, regardless of the price included in the response to the RFP.¹² Such a proposal is one-sided in favor of the bidder. Such an arrangement, which would be beneficial to the bidder, would be unfair to the utility and its ratepayers. The utility and its ratepayers would be required to “accept” the bidder’s price, no matter what the price offered, as long as the bidder agreed with the SOC. Such a concept does not further the objectives of

¹² HREA acknowledged that the price would not be included in the SOC. See HREA OB, Exhibit A at 15 (HREA argued that “[a] bidder will not be able to provide firm price for delivered capacity, unless the contract terms and conditions are included in the RFP, i.e., in a standard offer contract”). In actuality a “standard offer” contract would specify the price, as well as the other terms and conditions. In such a case, it is not clear what the purpose of the competitive bidding process would be.

competitive bidding, in particular the objective to acquire the lowest reasonable cost resource.

Third, under HREA's proposal, the utility and its ratepayers could end up having to enter into multiple contracts for multiple resources. HREA's proposal requires the utility to sign the SOC if the bidder agrees with the terms and conditions in the contract included with the RFP. Apparently the utility would be required to sign the contract if more than one bidder signed and returned the contract to the utility. This would result in the utility and its ratepayers paying for more resources than necessary.

In addition, while the utility is bound by the terms and conditions included in the SOC, the bidder is free to propose revisions to the SOC. See HREA OB, at 10.¹³ HREA's proposed SOC is also subject to negotiations just like the proposed form of contract included in the Stipulating Parties'¹⁴ proposed competitive bidding process.

C. APPROVAL OF THE RFP

HREA recommends that the Commission approve each RFP before issuance. HREA OB, Exhibit A at 18, 46. HREA's suggestion that the RFP be formally approved by the Commission before issuance should be rejected.

Any process requiring formal approval of the RFP before issuance (rather than an informal process permitting regulators to comment on the RFP) could substantially and needlessly delay an RFP process, and render it unworkable. The Commission would formally approve the IRP Plan, and any determination therein to conduct or not conduct an RFP process, and the proposed scope of the RFP process. The Commission also would formally approve the outcome of the RFP process (or other resource procurement process), whether the outcome was a

¹³ HREA contended that bidders that respond to the solicitation bid package may include a "proposed power purchase agreement (PPA) based on the SOC (with any proposed modifications to the SOC)."

¹⁴ The HECO Companies, Consumer Advocate, and KIUC are collectively referred to as the "Stipulating Parties".

utility-built or utility-owned facility or facilities, or an IPP-owned facility or facilities, or a combination thereof. HECO Companies OB at 6, 109-110.

The HECO Companies provided a discussion of a Florida Public Service Commission proceeding to illustrate why such a seemingly simple matter as formal approval of the RFP by a commission is anything but simple. See HECO Companies OB at 110-14. The steps that should actually be taken must take into account limitations on the resources of the utilities implementing the process, and the time required to take the step. For example, obtaining Commission approval of an RFP before it is issued might minimize later issues regarding the RFP, but such a requirement could add substantially to the time required to conduct an RFP process (particularly if the approval was made in a “contested case” proceeding). HECO Companies OB at 114. Thus, prior approval should not be required.

D. ROLE OF THE INDEPENDENT OBSERVER

HREA proposes that the independent observer be hired by and report to the Commission. HREA OB at 10 n.5; see HREA OB, Exhibit A at 40. In addition, HREA proposes that the independent observer review and evaluate all proposals and provide recommendations for awards to the Commission. HREA OB at 11. HREA’s proposals should be rejected.

Generally in RFP processes on the mainland, it is the utility that makes the decision to hire the independent observer.¹⁵ Mr. Oliver’s firm generally is hired by the utility with the “blessing” of the regulatory body’s staff or the staff being aware of the hiring. The utility, rather than the Commission, should enter into a contract with the independent observer. However, the

¹⁵ Mr. Oliver is aware of only two cases where the regulatory body has hired the independent observer (i.e., Georgia and Utah). In all other cases in which he has been involved, the utility has hired the independent observer. HECO Companies OB at 106.

independent observer would report to and consult with both the utility and the Commission.¹⁶

Mr. Oliver found that the process of being hired by the regulatory body may be somewhat more costly because of the requirements that are placed on the independent observer. HECO Companies OB at 106.

A decision-making role is beyond the function of an independent observer. Mr. Oliver testified at the panel hearing that the decision-making role is viewed as belonging to the utility. Mr. Oliver was not aware of any conditions in which an independent observer has made decisions on resource selection or reopening an RFP or anything of that sort. HECO Companies OB at 103.

Mr. Oliver's observations are consistent with the comment of investor-owned utilities in a proceeding before the Florida Public Service Commission, *In re: Proposed revisions to Rule 25-22.082, F.A.C., Selection of Generating Capacity*, Docket No. 020398-EQ. In a letter to the Chairman of the Commission dated September 6, 2002, the IOUs noted:

The Commission has recognized in the past that a provision for third-party evaluation of bids and selection of the project shifts the responsibility for capacity additions to an unregulated entity. This shift would be contrary to the statutory obligation of the IOUs to provide adequate and reliable service to their customers. Part of an IOU's statutory obligation to serve is to be responsible for and to justify its selection in the bidding process.

The revised rules approved by the Florida Commission in that proceeding did not provide for evaluation of proposals by a third-party.

¹⁶ It is possible for an independent observer to report both to the utility and the regulatory body. For instance, Mr. Oliver's role in an RFP process in Louisiana was to act as an intermediary between Southwestern Electric Power Company and the Louisiana commission's staff. Mr. Oliver received comments from the utility and from the commission staff. In some cases, he agreed with what the utility proposed. In other cases, he did not and he reported that to the commission staff. It was basically a three-party arrangement. Mr. Oliver's role was to report to the staff and provide the utility with the best information about the process and what he thought was fair. The process in Oklahoma was similar. HECO Companies OB at 107.

E. **PROVIDING BIDDERS ACCESS TO UTILITY-OWNED GENERATING SITES**

HREA wants the utility to be required to make its undeveloped generation sites available to bidders. HREA OB, Exhibit A at 33.

A utility should not be required to make its undeveloped generation sites available to bidders. Instead, the utility should be allowed to choose to offer one or several utility-owned and/or controlled sites to bidders in a competitive bidding process. See Proposed Framework, ¶ II.A.3.

The question of whether the Commission should require the utility to make its undeveloped generation sites available to bidders, should include consideration of factors such as (1) the anticipated specific non-technical terms of potential proposals, (2) the feasibility of the installation and (3) the utility's anticipated future use of the site.¹⁷ HECO Companies OB at 85.

In addition to these factors, there are other reasons why the decision to offer undeveloped utility sites to bidders should be reviewed on a case-by-case basis with the final decision being made by the utility. An issue of primary concern is reliability. Utility-controlled sites are valuable assets that have been secured to benefit the customers over the long term. To ensure long-term reliability of supply, it would be beneficial for the utility to maintain site control to ensure power generation resources could be constructed to meet system reliability requirements. This is particularly true in Hawaii, where the number of sites that are available to locate new generation are limited.¹⁸ HECO Companies OB at 85-86.

¹⁷ These factors are discussed in the HECO Companies Opening Brief on pages 84 to 85.

¹⁸ Sites in which power plants can be located are valuable as there are numerous permitting and approval processes (e.g., air, water, land use) that must be successfully completed before a power plant can be located at the site. The HECO Companies may need to start certain permitting processes in order to be able to site power plants on its properties in the future, and even existing sites may become unavailable in the future because some of the air quality requirements have changed or the type of generation the utility now wants to site cannot be located there because of these other permitting restrictions. HECO Companies OB at 87-88.

A concern that bears directly on reliability is that offering utility-controlled sites may reduce the flexibility of the utility to perform crucial parallel planning for a utility-owned option to backup the unfulfilled commitments of IPP developers of generation. Hawaii utilities do not have the option to acquire power from other jurisdictions, or even other islands. A project developer's default could occur at any time, so parallel planning may extend well into the development process. If the site was made available for the developer's use, that could largely preclude the utility from utilizing that site for its parallel planning. As a practical matter, in order to carry out parallel planning in the context where the utility has turned over its site to the winning bidder, the parallel planning would have to occur on some other site. HECO Companies OB at 86.

Further, making a utility site available to bidders could also have an adverse impact on the utility's contingency plan. Taking the Campbell Industrial Park site as an example, there is a second combustion turbine that would be the contingency measure if load growth increases faster than anticipated. Once the site is turned over to the developer, HECO has lost the ability to implement its contingency plan for accelerated load growth. HECO Companies OB at 86-87.

Moreover, offering utility-controlled sites may reduce the full value hoped to be gained in a competitive solicitation process. Bidders are not encouraged to develop creative options to meet Hawaii's needs, but instead will be more likely to select the utility site possibly limiting the range of resource options bid. HECO Companies OB at 87.

In addition to the concerns described above, there are legal concerns with the utility being required to offer its site to a bidder. There are questions as to whether the Commission has the legal authority to impose such a requirement. There is no explicit authority to require the utility to dispose of its site. Even if the basis was simply to foster competition, that would be an

insufficient basis because the regulation of public utility scheme does not contemplate that the purpose of that scheme is to foster competition. There is no authority for the Commission to order the utility to dispose of its property, which, in effect, is what it would be doing. Moreover, the Commission cannot condemn the utility's property.

There may also be complex legal issues associated with the sale or lease of a utility-controlled site, such as ensuring that the bidder and not the utility absorbs any environmental liability associated with the site. HECO Companies OB at 88.

Mr. Oliver has seen the issue of making utility sites available come up in some other processes in which he has been involved. However, he is not aware of any cases on the mainland where the utilities have been required to offer a site. Some have offered sites for third-party bids, but most have not. The general situation on the mainland is that it is at the discretion of the utility to make that determination.¹⁹ HECO Companies OB at 89.

F. UTILITY COST RECOVERY

HREA's Position

If utility self-build projects are allowed to participate in the RFP process, then HREA apparently takes the position that the utility should be held to the lower of its costs or its bid. See HREA OB, Exhibit A at 9, 48.

As addressed in the HECO Companies Opening Brief, it is neither necessary nor appropriate to impose an arbitrary "cap" on the utility's recovery of its construction costs or operating and maintenance ("O&M") costs. Before imposing such a cap, there would have to be a clear showing that such a departure from traditional cost-of-service rate-making is necessary, or that a focus on construction and/or O&M cost risk makes sense, or that the unique Hawaii

¹⁹ The HECO Companies discussed how other jurisdictions deal with the subject of making generation sites available to bidders in their Opening Brief on pages 89 to 91.

market, which does not include short-term market-based options, or power that can be imported from other jurisdictions), has been considered, or that unintended negative consequences have been considered.

In order to treat the utility in the same manner as an IPP, the utility should be allowed, in effect, to have a contract with itself, meaning that it would not be limited to a cost-of-service recovery, but could recover its purchase price with itself. Otherwise, the financial benefits for the utility would be limited on the upside, but it would absorb all the downside risk. By contrast, there would be no limit on an IPP's ability to realize a financial benefit on an identical project.²⁰

Moreover, in order to put a utility's self-build project on an equal footing with an identical IPP project, the Commission would have to give up jurisdiction over that power plant. The only mechanism to control, even in a limited way, a power plant operated by an IPP is through a power purchase contract. There is no regulation by the Commission of an IPP's power plant. The Commission would have to assume the same position with respect to a utility's power plant if it were going to treat the utility like an IPP.

Mr. Oliver observed that most jurisdictions do not impose a cap on recovery, but allow a cost-of-service type bid. If the actual cost exceeds the bid price, there must be some justification of why the price was higher than estimated, with the recognition that if the utility underestimates by "50 percent to win the bid", there is going to be a prudence issue. If there is a justification for why those costs went up, then that would be part of the final determination of the cost. If there is some reasonable explanation to justify the increased costs, then that would be part of the prudence case, and the actual costs should be included in the utility's cost of service. Tr. (12/14)

²⁰ As a practical matter, however, it is not realistic for a utility to have a contract with itself, because the Commission would still regulate all aspects of the utility, and even if the utility brought the project in at a lower cost, that financial gain could be taken away through other regulation of the utility's cost of service.

at 755-57 (Oliver); see HECO Opening Brief at 129-34.

At the same time, the key to a fair bidding process is to ensure that whatever risk is involved for ratepayers under the adopted cost recovery mechanism is taken into account in the evaluation process when comparing the utility's self-build proposal versus bids from IPPs. For example, a utility's self-build option might be evaluated by including a contingency for some cost overrun rather than simply considering the estimated cost that the utility might project. Alternatively, a utility might choose to take on a risk of limiting the amount of its recovery, and it should be allowed to bid on that basis, but it would have to do so at the time it submitted its bid. Another possibility is that, if the utility is going to be able to adjust its in-service cost based on differences in financing cost, then bidders might be allowed to bid an option that allows them to adjust their capacity price based on changes in financing cost between the time they enter into the contract and the time that project enters into service (i.e., when they put into place long-term financing). Some of these alternatives can be taken into consideration in the options given to bidders. Some of these matters can be taken into consideration in how the utility's bid is evaluated.

Under the Proposed Framework, the regulatory treatment of utility-owned or self-build facilities will be cost-based, consistent with traditional cost-of-service ratemaking, wherein prudently incurred capital costs are included in rate base. Any utility-owned project selected pursuant to the RFP process will remain subject to prudence review in a subsequent rate proceeding with respect to the utility's obligation to prudently implement, construct and/or manage the project consistent with the objective of providing reliable service at the lowest reasonable cost. Framework, Section VI.D.

The Proposed Framework addresses the comparative effects of different cost recovery treatments by requiring that all differences between utility self-build and/or utility owned facilities be evaluated, and that the evaluation, in effect, be “validated” by the independent observer.

If proposed utility self-build facilities or other utility-owned facilities (e.g., turnkey facilities), or facilities owned by an affiliate of the host utility, are to be compared against IPP proposals obtained through an RFP process, the electric utility should retain an independent observer to monitor the utility's conduct of its RFP process, advise the utility if there are any fairness issues, and report to the Commission at various steps of the process. Proposed Framework, Paragraph III.H.7. As stated in this paragraph of the Framework, the utility could provide the independent observer with the utility’s evaluation of the unique risks and advantages associated with utility self-build or other utility-owned facilities, including the regulatory treatment of construction cost variances (both underages and overages) and costs related to equipment performance, contract terms offered to or required of bidders that affect the allocation of risks, and other risks and advantages of utility self-build or other utility-owned projects to consumers. The independent observer may validate the criteria used to evaluate affiliate bids and self-build or other utility-owned facilities, and the evaluation of affiliate bids and self-build or other utility-owned facilities.

In order to do this, the utility (in conjunction with the independent observer) should propose methods for making fair comparisons (considering both costs and risks) between the utility-owned or self-build facilities and third-party facilities. As noted in the Framework, such a comparison between self-build or other utility-owned facilities and IPP facilities may include modeling likely variation in construction costs, plant efficiency, plant outages, and/or operation

and maintenance costs and assigning a risk premium to the self-build or other utility-owned facilities, and the likely impact of IPP proposals on the utility's capital structure. Proposed Framework, Paragraph III.H.7.

Costs of Developing Self-Build Option

In addition, when responding to the Commission question II.A.2.b, which assumed that the utility has a legal obligation to submit a self-build option for each competitive bid process, HREA contended that “[t]he utility [should] not be allowed to recover any of its self-build proposal costs, regardless of whether their proposal wins”. HREA OB, Exhibit A at 9; see HREA OB, Exhibit A at 10, 49.

HREA's position on the utility's ability to recover the cost to develop its response to the RFP is unreasonable. In order to provide a self-build option in response to an RFP, the utility will have to conduct preliminary engineering and design work in order to provide the type of information that may be requested of bidders in the RFP. The preliminary engineering and design work will also be done by the other bidders and the cost of such work will likely be embedded in the bidders' proposed price (since the bidder will not do such work for free). This is one of the reasons why bidders only bid on projects for which they believe they have a chance to be the “winner”. HREA provides no justification as to why non-utility bidders should be treated differently from utility bidders with respect to the recovery of these costs.

In addition, this preliminary engineering and design work is generally included in the cost of utility projects that are ultimately added to a utility's rate base after a project has been placed in service. These preliminary engineering costs are necessary costs. It is unreasonable to treat such costs differently for purposes of competitive bidding.

One outcome of HREA's proposal is to create a disincentive for the utility to submit a response to a RFP. Such an outcome does not further the goals of competitive bidding, one of which is acquiring the lowest reasonable cost resource. As discussed in this Reply Brief, the utility self-build option has been selected as the lowest reasonable cost resource in competitive bidding processes in other jurisdictions.

G. TRANSMISSION PLANNING INFORMATION

The Consumer Advocate recommended that certain transmission planning information concerning the utility system should be provided to bidders as part of the RFP package (e.g., “[a]dvance identification zones . . . reflecting different identified levels of interconnection and transmission upgrade costs”, “schematic identifying preferred zones for locating generating facilities and foreseeable system costs that might be allocated to bidders within the different zones”). CA Responses at 112, 114.

There are practical limitations on the extent to which interconnection and upgrade costs for such zones can be determined in advance of receiving bids in an RFP. Interconnection and transmission upgrade costs for generating units tied to an isolated island system are highly dependent upon performance and operational characteristics of the generator and prime mover proposed. “Zones” can be provided along with general information on potential transmission infrastructure limitations or upgrades triggered with generation additions, but definitive interconnection and transmission upgrade costs can only be determined with specific design and performance information provided in bids.

The Consumer Advocate also suggested that “greater emphasis” be placed on the description of the transmission system that is included in filings under the IRP Framework as


such information may be beneficial to bidders in the competitive bidding process. CA Responses at 113.

Interconnection requirements and transmission upgrade requirements are specific to the generating unit proposed in a bid (e.g., location, size, operational mode, and performance of a generating unit). In addition, transmission upgrade requirements are also dependent upon many forecast assumptions, including load forecasts, DSM forecasts, and CHP forecasts. Further, identification of interconnection requirements and transmission upgrade requirements for every candidate generation resource in an IRP plan would be time consuming and would lengthen an IRP process. Therefore, it is more appropriate and more cost effective to provide guidance on interconnection requirements and transmission upgrade requirements to bidders in an RFP package rather than in an IRP plan. In an RFP package, the analysis of interconnection requirements and transmission requirements can be more focused on the solicited generating unit (or block of generation) using the most current forecast assumptions.

II. CONCLUSION

Based on the foregoing and the entire record herein, the HECO Companies respectfully request that the Commission approve the Stipulating Parties' Proposed Framework.

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CERTIFICATE OF SERVICE

I hereby certify that I have this date served a copy of the foregoing **REPLY BRIEF**, together with this Certificate of Service, by hand delivery and/or by mailing a copy by United States mail, postage prepaid, to the following:

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